08-0892
AUDIT—CORPORATE FRANCHISE
TAX YEARS: 2003-2004
SIGNED 04-05-2010

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER, Petitioner, vs. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	**FINDINGS OF FACT, CONCLUSIONS OF LAW, AND FINAL DECISION** Appeal No. 08-0892 Account No. ##### Tax Type: Corporate Franchise Audit Period: 7/03-6/04 Judge: Phan

Presiding:
R. Bruce Johnson, Commission Chair
D'Arcy Dixon Pignanelli, Commissioner
Michael J. Cragun, Commissioner
Jane Phan, Administrative Law Judge

Appearances:
For Petitioner: PETITIONER REP. 1, Attorney at Law
PETITIONER REP. 2, Attorney at Law
PETITIONER REP. 3, VP Finance, CFO, PETITIONER, Inc.
PETITIONER REP. 4, Director of Taxation, PETITIONER, Inc.

For Respondent: RESPONDENT REP. 1, Assistant Attorney General
RESPONDENT REP. 2, Assistant Attorney General

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for a Formal Hearing pursuant to Utah Code Secs. 59-1-501 and 63G-4-204 et al., on December 15, 2009. Based upon the evidence and testimony presented at the hearing, the Tax Commission hereby makes its:

FINDINGS OF FACT

1. Petitioner (the "Taxpayer") is appealing an audit deficiency for the period of July 1, 2003 to June 30, 2004. The Statutory Notice was issued on April 7, 2008. The Taxpayer timely appealed the audit and the matter proceeded to the Formal Hearing.

2. The Taxpayer is a multinational corporation with its commercial domicile is Utah.

3. The Taxpayer's operations are (PORTION REMOVED).[1] In the United States the line of business is primarily the (X) supply. In the countries outside the United States it provides (X) services as well. During the audit year at issue the Taxpayer had (#) processing plants, (#) customers and employed (#) worldwide. In addition to the United States, the Taxpayer's worldwide operations included businesses in (COUNTRIES LISTED).[2] The nature of the operation is such that sales need to be made within 100 miles of the processing plants. There were no sales between the foreign subsidiaries and domestic subsidiaries.

4. The Taxpayer and its unitary domestic subsidiaries filed a water' edge combined return for the audit period. The original Utah return was filed on April 15, 2005. On the return the Taxpayer reported apportionable income of $$$$$, an apportionment fraction of 8.3316%, apportioned income of $$$$$ and Utah tax of $$$$$. The Taxpayer amended the return on March 2, 2007 reporting apportionable income of $$$$$, apportionment fraction of 6.9353%, apportioned income of $$$$$ and Utah tax of $$$$$. At the hearing the Taxpayer offered two alternatives to its amended return. The Taxpayer's first option was to reduce the apportionable income to $$$$$ and the second would reduce the apportionable income to $$$$$

5. In the original audit the Division had calculated apportionable income of $$$$$, an apportionment fraction of 4.5838%, apportioned income of $$$$$ and Utah tax of $$$$$. However, subsequent to the issuance of the original audit, the Division revised its deficiency to apportionment fraction of 4.2288%, apportionment income of $$$$$ and Utah tax of $$$$$ ("Amended Audit").

6. The Taxpayer had been a C corporation and converted to an S Corporation on July 1, 2004. All of the Taxpayer's foreign subsidiaries elected to be disregarded entities for federal tax purposes pursuant to federal regulations. Effective June 30, 2004 they were treated for tax purposes as having been liquidated under 26 U.S.C.A. Sec. 332. Because of this deemed liquidation during the audit year, federal law required the Taxpayer to include in its federal income the undistributed earnings and profits for each of the foreign subsidiaries. The undistributed earnings and profits were defined as the net positive earnings and profits determined under Treas. Reg. 1.367(b)-2(d)(2). This consists of all the undistributed income of the subsidiary accumulated over its entire period of existence.

7. The Division considered the undistributed earnings and profits to be 'deemed dividends' for both federal and state tax purposes. The Taxpayer argued the earnings and profits were not 'deemed dividends.' However, both sides agreed the Taxpayer was required to claim these, and did, in fact claim these

1 Petitioner's Hearing Exhibit 1.
2 Petitioner's Hearing Exhibit 3.

amounts on its federal return as part of its taxable income. The Taxpayer reported $$$$$ foreign dividend income on its Federal 1120, Schedule C, Line 13.[3] Of this amount $$$$$ are the 'deemed dividends' that are at issue in this matter, and $$$$$ were paid dividends.

8. On its Utah TC-20 Schedule C4 the Taxpayer had taken a deduction of 50% of the $$$$$ received as paid dividends. The Division was in agreement with this.

9. However, also on the Utah TC-20 Schedule C the Taxpayer had taken $$$$$ as a 100% deduction for the deemed dividends. The Division disagreed with this and disallowed the 100% deduction. It was the Division's position in the audit that pursuant to Utah Code Sec. 59-7-106(11) the Taxpayer was entitled to take only a 50% deduction and the Division had adjusted the amount in the audit accordingly. The Division also reduced this 50% dividend deduction by related expenses, which it stated was required by Utah Code Sec. 59-7-106(11). The Division's position after these changes was that the apportionable income was $$$$$, which was significantly higher than the $$$$$ in apportionable income that the Taxpayer had claimed on its amended return.

10. The 'deemed dividend' income of $$$$$ has not been apportioned or allocated to any other state.

11. Although in its audit the Division had increased the apportionable income substantially, the Division also allowed for factor relief, thereby reducing the Utah apportionment fraction to 4.2288%. On its amended return, the Taxpayer had claimed an apportionment fraction of 6.9335% including factor relief for only the paid dividends, as it had deducted 100% of the deemed dividends. On its original return the Taxpayer had not included any factor relief. The Division allowed for factor relief as proved by Utah Code Sec. 59-7-106(11)(b) for both the paid and the deemed dividends. The Division's factor representation was calculated by including up to 100% of the current year factors of the foreign subsidiaries, where the numerator was the paid or deemed dividend by the foreign subsidiary and the denominator the current year earnings and profits of the foreign subsidiary. The inclusion of factor relief results in $$$$$ less tax being assessed by the Division than if no factor relief had been employed.[5]

12. With the deemed liquidation during the audit year at issue, the domestic subsidiaries were not subject to tax on their undistributed earrings, while the foreign subsidiaries' undistributed earnings were being taxed by the Division in the audit, subject to the 50% deduction and factor relief. Of course for the years prior

3 Petitioner's Hearing Exhibit 10.

4 Respondent's Hearing Exhibit 4.

to the deemed liquidation, the income of the domestic subsidiaries included in the Taxpayer's combined report was apportionable to Utah in the years in which it was earned. While for the foreign subsidiaries the income earned during the years prior to the deemed liquidation was not taxable to Utah. Dividends, however, paid by the foreign subsidiaries were taxable to Utah in the year paid, while dividends from the domestic subsidiaries included in the combine report in the prior years would not have been taxable to Utah.

13. The Taxpayer points out that one of its domestic subsidiaries, SUBSIDIARY ("SUBSIDIARY") had undistributed earnings from years in which SUBSIDIARY was not included in PETITIONER's combined report for Utah. SUBSIDIARY was an existing operating company before it was acquired by a subsidiary of the Taxpayer in 1990.[6] At the time this corporation was acquired it had $$$$$ in retained earnings.[7] For the years when SUBSIDIARY was included in the Taxpayer's combined report the domestic subsidiary's income was subject to taxation in the state, but for the years before this subsidiary was included in the Taxpayer's combined report the income was not included in the Taxpayer's combined report. However, as the Division noted, SUBSIDIARY was presumably subject to tax in Utah prior to when it was included on the Taxpayer's combined report because it was doing business in Utah at that time.

14. The Taxpayer contrasted the treatment upon the deemed liquation of the domestic subsidiaries with the foreign subsidiaries. The Taxpayer gave the example of the subsidiary COMPANY A. It had acquired 47% of the subsidiary in 1963 and then in 1995 an additional 48.4% of the issued and outstanding shares for a total ownership of approximately 96%. At the time of the 1995 purchase, COMPANY A had retained earnings of approximately $$$$$.[8] When this foreign subsidiary was treated for tax purposes as having been liquidated during the audit year, all of its undisturbed income from all the years that it had been in business was treated as taxable income by the Division in the form of deemed dividends.

15. The Taxpayer's representatives point out that these undistributed earnings and profits of its foreign subsidiaries were earned over the period of many years. However, the Division's factor relief was limited to including up to 100% of the current year factors of the foreign subsidiaries. In is calculation to determine the factor relief, the Division's numerator was the paid dividends plus all undistributed earnings and profits of the foreign subsidiaries from the number of years that the business had operations. However, the denominator was limited to only the current year's earnings and profits of the foreign subsidiary. It was the

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5 Respondent's Hearing Exhibit 6.
6 Petitioner's Hearing Exhibit 4.
7 Petitioner's Hearing Exhibit 5, pg.4.
8 Testimony of PETITIONER REP. 3.

Taxpayer's position that if the foreign factors for the year the income was earned was considered the income apportioned to Utah would be $$$$$. Alternatively, that the percentage of the factors taken into account under the Utah formula without the 100% limitation would result in a Utah apportionment fraction of .021302. Based on this, of the $$$$$ in apportionable income, just $$$$$ would be apportioned to Utah.[9]

16. The Taxpayer provided hypothetical mathematical illustrations of the affect of removing the 100% limitation from the foreign factors would affect the Utah apportionment factor. This illustrated the difference if dividends were paid out each year over a four year period and taxed in the year received verses being paid out in a lump sum in the fourth year, which is analogous to the treatment of the undistributed earnings and profits that were deemed dividends in the tax year at issue. This calculation did show under the hypothetical numbers that with the 100% limitation on the foreign factors and the lump sum payment on year four, the amount of the foreign dividends apportioned to Utah were substantially higher by 272% or more, than if the dividends had been paid out annually. The numbers also showed if the 100% limitation on the foreign factors was removed and the foreign dividend paid in a lump sum in the fourth year, the amount of the foreign dividend apportioned to Utah was 42% to 46% less than the amount if one-fourth of the dividends had been paid out annually and been taxed in the year received.[10]

APPLICABLE LAW

During the audit period at issue Utah law required a corporate franchise tax at Utah Code Sec. 59-7-104(1) (2004)[11] as follows:

> Each domestic and foreign corporation, except those exempted under Section 59-7-102, shall pay an annual tax to the state based on its Utah taxable income for the taxable year for the privilege of exercising its corporate franchise or for the privilege of doing business in the state.

"Unadjusted income" is defined at Utah Code Sec. 59-7-101(27) (2004). This section was subsequently modified for the audit period at issue provided:

> "Unadjusted income" means federal taxable income as determined on a separate return basis before inter company eliminations as determined by the Internal Revenue Code, before the net operating loss deduction and special deductions for dividends received.

9 Exhibits B & C of Petitioner's Opening Brief,
10 Exhibit A of Petitioner's Reply Brief.
11 The Commission cites to and applies the law in affect during the audit period.

Subtractions from 'unadjusted income' are provided at Utah Code Sec. 59-7-106. The statutory subtraction provided that are relevant to the issues in this decision are at Subsection 11 of Section 106 and state:

> (a) 50% of the dividends deemed received or received from subsidiaries which are members of the unitary group and are organized or incorporated outside of the United States unless such subsidiaries are included in a combined report under Section 59-7-402 or 59-7-403. In arriving at the amount of the dividend exclusions, the taxpayer shall first deduct from the dividends deemed received or received, the expense directly attributable to those dividends. Interest expenses attributable to excluded dividends shall be determined by multiplying interest expense by a fraction, the numerator of which is the taxpayer's average investment in such dividend paying subsidiaries, and the denominator of which is the taxpayer's average total investment in assets;
>
> (b) in determining income apportionable to this state, a portion of the factors of a foreign subsidiary whose dividends are partially excluded under Subsection (11)(a) shall be included in the combined report factors. The portion to be included shall be determined by multiplying each factor of the foreign subsidiary by a fraction, but not to exceed 100%, the numerator of which is the amount of the dividend paid by the foreign subsidiary which is included in adjusted income, and the denominator of which is the current year earnings and profits of the foreign subsidiary as determined under the Internal Revenue Code;

Utah law provides for a deviation from the standard allocation and apportionment provisions at Utah Code Ann. 59-7-320 as follows:

> Notwithstanding any other provision of this part, if the allocation and apportionment provisions of this part do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the commission may require, in respect to all or any portion of the taxpayer's business activity, if reasonable:
> (1) separate accounting;
> (2) the exclusion of any one or more of the factors;
> (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

CONCLUSIONS OF LAW

1. With the deemed liquidation of the foreign subsidiaries during the audit year, the Division

correctly treated the undistributed earnings and profits from these foreign subsidiaries as taxable in calculating the apportionable income in its audit. These were 'dividends deemed received' for purposes of Utah Code Sec. 59-7-106(11). Although the Taxpayer argued that this undistributed income was not technically a dividend or a 'deemed dividend,' the Taxpayer had reported these undistributed earnings and profits on Line 13 of Schedule C- Dividends and Special Deductions, of its federal Corporation Income Tax Return for the audit year at issue. The total amount reported on that line, which is titled "Other Dividends from Foreign Corporations," was $$$$$. Included in this amount was the $$$$$ undistributed earnings and profits from the foreign subsidiaries and the $$$$$ which were dividends actually paid during the year by the foreign subsidiaries. Therefore, the Taxpayer had reported the earnings and profits as dividends on its federal return. At the hearing the Taxpayer's representative argued that perhaps the earnings and profits did not need to be reported as dividends, but was unable to provide an alternative manner in which they could properly be reported on the Federal return. In fact by reporting the dividends in this manner the Taxpayer was able to take advantage of the federal foreign tax credits. Clearly the manner in which this amount was reported supports the Division's contention that they are 'deemed dividends' and subject to the same 50% deduction provision as the paid dividends. It is also consistent with the definition of dividend as a distribution out of earnings and profits. *See* IRC Secs. 316 and 6042. Based on the evidence and information presented at the hearing, the Commission concludes that the Division properly treated the undistributed earnings and profits as 'deemed dividends' for purposes of the Utah Corporate Franchise and Income Taxes Act.

2. Based on this conclusion that the Division correctly treated the undistributed earnings and profits as 'deemed dividends,' the Division's limiting to 50% the deduction for the foreign deemed dividends is based on correct application of the law. There is no basis in the statutory provisions as they are currently written for the 100% deduction that the Taxpayer had made for the deemed dividends. Utah Code Sec. 59-7-106 (11) (a) provides for a deduction of only 50% of the "dividends deemed received" from "members of the unitary group and are organized or incorporated outside of the United States." The Division has properly allowed for the deduction.

3. Further, Utah Code Sec. 59-7-106(11)(b) provide for additional relief from Utah tax on these dividends from the foreign subsidiaries. This has been referred to by the Division as factor relief. This relief reduces the portion of the unitary group's income that is taxable to Utah. Subsection (b) provides that a portion, not to exceed 100%, of the foreign subsidiary's factors are included in the combined report factors. The portion is based on the numerator being the amount of the dividend paid by the foreign subsidiary, which

is included in adjusted income and the denominator of which is the current year earnings and profits of the foreign subsidiary as determined under the Internal Revenue Code. The Division's application of these provisions reduced the Utah apportionment fraction to 4.2288%. This resulted in $$$$$ less Utah tax than if no factor relief had been allowed in the Division's audit. Application of both the 50% deduction as well as the factor relief significantly decreased the amount of Utah income tax charged against the foreign dividends either paid or deemed to be paid. In its amended audit, the Division's computation of the factor relief was a technically correct application of Subsection (b).

4. The Taxpayer argues that the Division's tax treatment following the deemed liquation of both the domestic and foreign subsidiaries is facially discriminatory and prohibited by the U. S. Constitution. For this reason the Taxpayer argues that 100% of the deemed dividends should be deducted from its apportionable income. The Taxpayer cites to *Kraft General Foods, Inc. v. STATE 1 Dept. of Revenue & Finance*, 505 U. S. 71 (1992). With the deemed liquidation during the audit year at issue, the Division had found taxable the foreign subsidiaries undistributed earrings and profits accumulated from all the years that the subsidiary had been in business, subject to the 50% deduction and factor relief. The Taxpayer argues that this is inequitable with the tax treatment of the domestic subsidiaries. As discussed below, the Commission is not persuaded by the Taxpayer that this perceived inequitable treatment justifies the Taxpayer's 100% deduction of the deemed dividends, which is the Taxpayer's solution so that the tax would be in compliance with the Commerce Clause of the United States Constitution. The Commission is aware, however, that the Courts have consistently held that administrative agencies do not have the authority to determine the constitutionality of legislative enactments.[12]

5. The Taxpayer argues, in the alternative that if the Commission upholds the Division's inclusion of 50% of the deemed dividends instead of deducting 100% as the Taxpayer requests, the Commission should adjust the apportionment formula used by the Auditing Division. The Taxpayer argues that the formula used by the Division results in a gross distortion of the income apportioned to Utah. Utah Code Sec. 59-7-320 provides for a deviation from Utah's ordinary allocation and apportionment provisions when it does not "fairly represent the extent of the taxpayer's business activity in this state." The Taxpayer argues in addition to the state law, the Commission is required to modify the apportionment formula to comply with the Commerce Clause of the United States Constitution. Although, the Commission finds that the

12 *Nebeker v. Utah State Tax Commission*, 2001 UT 74 (Utah 2001).

Taxpayer has not presented an alternative more reflective of the business transacted in Utah,[13] the Commission concludes that an adjustment under this section is appropriate. Subsection (4) of Utah Code Sec. 59-7-320 provides that the Commission may employ "any other method to effectuate and equitable allocation and apportionment of the taxpayer's income." As discussed more fully below, it is appropriate to make an adjustment by excluding from the apportionable income any undistributed earnings and profits of the foreign subsidiaries that can be attributed to a period of time before they had become a subsidiary of the Taxpayer.

DISCUSSION & ANALYSIS

The Commission considers the two arguments offered by the Taxpayer for relief in this matter. The first argument is primarily a constitutional argument, that application of the statute by the Division to deny the Taxpayer's 100% deduction of the deemed dividends violates the Commerce Clause of the U. S. Constitution. The Taxpayer argues that the Division's tax treatment following the deemed liquation of both the domestic and foreign subsidiaries is facially discriminatory.

With the deemed liquidation during the audit year at issue the Division included as apportionable the foreign subsidiaries undistributed earrings and profits accumulated from all the years that the subsidiary had been in business (the deemed dividends), subject to the 50% deduction and factor relief. This was different from the tax treatment of the domestic subsidiaries. For the years prior to the deemed liquidation, the income was apportionable in the year earned by the domestic subsidiaries, but only for those subsidiaries included in the Taxpayer's combined report for that year. As with the tax treatment of income, the tax treatment of dividends is different for the foreign subsidiaries and domestic subsidiaries. For the Foreign subsidiaries, the income earned during the years prior to the deemed liquidation was not taxable to Utah. Dividends, however, paid by the foreign subsidiaries were taxable to Utah in the year received. Dividends from the domestic subsidiaries included in the combined report would not have been taxable to Utah in the year received because the income was taxable to Utah.

The Taxpayer pointed out that the United States Supreme Court in *Kraft* declared an STATE 1 tax statute to be in violation of the Commerce Clause because it resulted in the discriminatory inclusion of foreign

13 The Division argues the appropriate burden to show an adjustment should be made to the apportionment formula is that the taxpayer must show by "clear and cogent evidence" that the apportionment is "out of all proportion to the business" transacted in Utah. This is the test set out by the United States Supreme Court for analyzing interstate apportionment formulas in *Hans Rees' Sons, Inc. v. State of North Carolina ex rel. Maxwell*, 283 U.S.123, 135 (1931). The Taxpayer points out, however, that the *Hans Rees* case did not involve international taxation. The Taxpayer argues herein that due to the international subsidiaries the test is really as set out by the court for analyzing whether a state tax statue satisfies the Commerce Clause.

dividends in Kraft's STATE 1 taxable income where domestic dividends were excluded. *Id*. at 82. The Division distinguished Kraft because STATE 1 was a single-entity reporting state. The Division cites to, and Taxpayer acknowledges, that since the Court's decision in *Kraft*, several state courts have held that in water's edge combined reporting states, like Utah, it is permissible to tax dividends paid from foreign subsidiaries differently than those paid from domestic subsidiaries.[14] The Division argues that there is a taxing symmetry in water's edge combined reporting states in the taxation of dividends from the current year's earnings paid from the foreign subsidiaries and the taxation of the income of the domestic subsidiaries. The water's edge combined report includes the income earned by unitary domestic subsidiaries, but does not include the income of the unitary foreign subsidiaries.

The Taxpayer did not contest the notion of taxing symmetry as it related to the taxation of dividends from the current year's earnings paid by the foreign subsidiaries verses taxation of the current year's income of the domestic subsidiaries. The Taxpayer argues there is no such symmetry when the tax is triggered by the section 332 deemed liquidation. In the situation of the deemed liquidation, all of the undistributed earnings and profits of the foreign subsidiaries going back to the commencement of the operations in that subsidiary become deemed dividends. Some of these undistributed earnings and profits were earned before the Taxpayer had acquired the subsidiary. The Taxpayer points out that although under the section 332 liquidation the undistributed earnings and profits are included on the federal return as dividends, it is because the liquidation presents a complication with the foreign tax credit. To deal with the unused foreign tax credits, the U.S. parent includes in its federal table income all the undistributed earnings and profit and then claims all of the unused foreign tax credits. Utah law does not allow foreign tax credits.

The Taxpayer distinguished the tax treatment resulting from the section 332 deemed liquidation on the domestic subsidiaries. For the years that the domestic subsidiary was included in the Taxpayer's combined reports the current income from the domestic subsidiary for each year was apportionable. But if there was a domestic company operating outside of Utah for a number of years before it became a subsidiary of the Taxpayer and included in the Taxpayer's combined report, after the section 332 deemed liquidation, the Taxpayer would not be taxed on the undistributed earnings and profits of the subsidiary that were earned for the years before it became a subsidiary of the Taxpayer. This is in contrast to the treatment of the foreign

14 *General Electric Co. v. Commissioner, N.H.Dep't of Revenue Admin*., 914 A.2d 246 (N.H. 2006); E.*I. Du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82 (Me. 1996). *Caterpillar, Inc. v. N.H. Dep't of Revenue Admin*., 714 A.2d 56 (N.H. 1999). *Fujitsu IT Holdings, Inc. v. Franchise Tax Bd*., 120 Cal. App. 4th 459 (1st Dist. 2004), review denied, (Oct. 20, 2004).

subsidiaries. It was this disparate treatment that the Taxpayer argued was facially discriminatory and in violation of the U.S. Constitution.

Although it is possible to invent a hypothetical situation where a foreign subsidiary and domestic subsidiary were subject to this disparate treatment, the Taxpayer was unable to provide a concrete example of this occurring among its subsidiaries. The nearest example to this hypothetical offered by the Taxpayer was a comparison between SUBSIDIARY ("SUBSIDIARY") and COMPANY A. SUBSIDIARY had operated in the United States for a number of years before it became a domestic subsidiary of the Taxpayer and was included in the combined reporting. After the section 332 deemed liquidation the undistributed earnings and profits accumulated in the years prior to it being included in the combined report are not apportionable to the Taxpayer. However, as the Division noted, although SUBSIDIARY had not been included in the combined reporting of the Taxpayer in the prior years it had been doing business in Utah and therefore the income had been subject to tax in Utah during those years. COMPANY A had been operating for a number of years before it became a subsidiary of the Taxpayer. As a foreign subsidiary, after the section 332 liquidation all of its undistributed earnings and profits, including those from the period before it became a subsidiary, were included in the apportionable income subject to the 50% limitation.

The Taxpayer pointed out that if SUBSIDIARY had not been doing business in Utah prior to becoming a subsidiary the tax treatment would clearly be discriminatory. It is not unlikely that there is, or has been, a Utah corporate taxpayer with both domestic and foreign subsidiaries that had existed outside of the state of Utah prior to being included in a combined return when the corporate taxpayer went through a 332 liquidation. However, the mere possibility that this situation could occur is not sufficient basis to find the current statutory scheme unconstitutional or show there was not some reasonable taxing symmetry of they type noted by the Court in E.I. Du Pont, 914 A.2d at 88.[15] In this case the foreign dividends are not fully included in apportionable income because of the 50% deduction and additional factor relief. Allowing the Taxpayer to deduct 100% of the deemed dividends as it had on the amended return would result in a larger inequity, but one more favorable to the foreign subsidiaries than for the domestic subsidiaries. Ultimately the Commission

15 The Division provided a copy of a decision issued on December 28, 2009 by the Tax Commission of the State of STATE 2, for its appeal In the matter of the Protest of PETITIONER, Inc. This decision involved the same Taxpayer, deemed liquidation and deemed dividends that are at issue before the State of Utah. The STATE 2 Tax Commission upheld the tax assessment on the deemed dividends. The Division also provided *Fujitsu IT Holdings, Inc. v. Franchise Tax Board*, 120 Cal. App. 4th 459 (Cal. Crt. Apps. 2004). In that case the California Court of Appeals held that taxation of dividends from foreign subsidiaries did not violate the commerce clause of the United States Constitution.

is not persuaded by the Taxpayer that it would be justified in deducting 100% of the deemed dividends based on provisions of the Commerce Clause of the United States Constitution.

The Taxpayer's second argument is if the Commission upholds the Division's denial of the 100% deduction of deemed dividends, the Commission should adjust the apportionment formula used by the Auditing Division. The Taxpayer argues that the formula used by the Division results in a gross distortion of the income apportioned to Utah. Utah Code Sec. 59-7-320 provides for a deviation from Utah's ordinary apportionment formula when it does not "fairly represent the extent of the taxpayer's business activity in this state." The Utah Supreme Court has addressed the issue of adjusting the apportionment factors in two cases. In *Kennecott Copper Corp. v. State Tax Commission*, 493 P.2d 632 (Utah 1972) the Court concluded that the apportionment ratio could be adjusted when the statutory formula did not reflect the actual business activity in the state. The Court also sanctioned an adjustment to reflect the taxpayer's activity in the state *in Deseret Pharmaceutical Co. v. State Tax Commission*, 579 P.2d. 1322 (Utah 1978). The Taxpayer also argues in addition to the state law the apportionment formula should be modified under the Commerce Clause of the United States Constitution. It is the Taxpayer's contention that to prove the statutory apportionment formula is unconstitutional as applied by the Division, the Taxpayer need only show one of the following: 1) it results in a tax that is out of proportion to the business transacted in this state; 2) creates a substantial risk of international multiple taxation; or (3) prevents the Federal Government form speaking with one voice.[16] The Taxpayer argues that the Division's apportionment results in a tax that is out of proportion to the business transacted in Utah.

Although, the Commission finds that there is a basis for deviation from the standard allocation and apportionment provisions, it is not convinced that the Taxpayer's alternative is more reflective of the business transacted in Utah. Certainly the Taxpayer's requested adjustment results in a lower apportionment ratio mathematically, but that alone is not sufficient.[17] The Utah statutory structure already includes a lesser amount of the income from foreign subsidiaries than domestic by allowing a 50% reduction under Utah Code Sec. 59-

16 The Taxpayer argues the appropriate test is whether the tax statue satisfies the Commerce Clause and cites to *Complete Auto Transit, Inc. v. Brady*, 430 U.S.274 (1977) and *Japan Line, Ltd. V. County of Los Angeles*, 441 U.S. 434, 451 (1979).

17 The Division argues the appropriate burden to show an adjustment should be made to the apportionment formula is that the taxpayer must show by "clear and cogent evidence" that the apportionment is "out of all proportion to the business" transacted in Utah. This is the test set out by the United States Supreme Court for analyzing interstate apportionment formulas in *Hans Rees' Sons, Inc. v. State of North Carolina ex rel. Maxwell*, 283 U.S.123, 135 (1931). The Taxpayer points out, however, that the *Hans Rees* case did not involve international taxation. The Taxpayer argues herein that due to the international subsidiaries the test is as set out by the court for analyzing

7-106(a) and factor relief at Subsection 106(b) that have both been applied by the Division in this matter. The Taxpayer argues in addition to these provisions, which by application reduce the amount of the foreign dividends and deemed dividends subject to tax in Utah, an additional adjustment should be made by removing the 100% limitation of the foreign factors in the apportionment formula.

The Taxpayer's formula would be in addition to the 50% reduction that is already statutorily provided. The Commission understands the distinction between the paid dividends and deemed dividends for the foreign subsidiaries. Paid dividends are paid and taxed in the current year. The current year's earnings and profits are included in the apportionment ratio; therefore there is symmetry to the factor relief formula. The deemed dividends are an accumulation of many years' earnings and profits and yet the statutory factor relief would divide these only by the current years earnings and profits, which appears to be a mismatch.

However, based on the Taxpayer's own exhibit showing the affect of its adjustment, the Taxpayer's solution to remove the 100% limitation of the foreign factors, results in a smaller percentage, 42% to 45% less, of the deemed dividend being apportioned to Utah, then if the amount would have been paid out each year over a period of years, and taxed in the year paid.[18] Given that the inclusion of the foreign income is already reduced by the 50% deduction and further by factor relief, the Taxpayer has not shown that its suggested changes to the apportionment factor results in a tax that is more in proportion to the business transaction in Utah.

The Commission does recognize that by capturing as apportionable income undistributed earnings and profits from foreign subsidiaries accrued in years prior to when the entity became a subsidiary of the Taxpayer would not fairly represent the extent of the Taxpayer's business activity in this state. Utah Code Sec. 59-7-320(4) allows the Commission to employ any other method to effectuate an equitable allocation and apportionment of the taxpayer's income. In order to reach a more equitable allocation it is appropriate under that subsection to remove from the apportionable income any of the deemed dividends of the foreign subsidiaries that can be attributed to a period prior to when that entity become a subsidiary of the Taxpayer.

Jane Phan
Administrative Law Judge

DECISION AND ORDER

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whether a state tax statute satisfies the Commerce Clause, which is a less stringent test.
18 Petitioner's Reply Brief, Exhibit A.

Based upon the foregoing, the Tax Commission sustains in part the Amended Audit for the period of July 1, 2003 through June 30, 2004, subject to the adjustment to the apportionable income described above. It is so ordered.

DATED this ________ day of _______________________, 2010.

R. Bruce Johnson
Commission Chair

Marc B. Johnson
Commissioner

D'Arcy Dixon Pignanelli
Commissioner

Michael J. Cragun
Commissioner

Notice of Appeal Rights: You have twenty (20) days after the date of this order to file a Request for Reconsideration with the Tax Commission Appeals Unit pursuant to Utah Code Ann. Sec. 63G-4-302. A Request for Reconsideration must allege newly discovered evidence or a mistake of law or fact. If you do not file a Request for Reconsideration with the Commission, this order constitutes final agency action. You have thirty (30) days after the date of this order to pursue judicial review of this order in accordance with Utah Code Sec. 59-1-601 et seq. and 63G-4-401 et seq.

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